
PCAOB FLASH REPORT

PCAOB Staff Issues Responses to Frequently Asked Questions Regarding Audits of Internal Control Over Financial Reporting

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Following the issuance of responses to frequently asked questions by the SEC staff earlier this week, the PCAOB staff subsequently followed suit with a “Staff Questions and Answers” document of their own. To understand the staff’s views, there is no substitute for a careful review of the document released by the PCAOB staff. Interested parties may go to http://www.pcaobus.org/QA_Staff_Internal_Control.pdf on the PCAOB website to obtain the document. In addition to certain general questions, this document addresses the following broad topics:

- Auditor independence
- Scope and extent of testing
- Evaluating deficiencies
- Multi-location issues
- Using the work of others
- Third party service organizations

Following are some of the points of view expressed by the PCAOB staff in the 26 questions listed in this document.

Auditor Independence

- The pre-approval requirement of audit committees applies to any internal control-related services, regardless of whether they are classified as audit or non-audit services for proxy disclosure purposes or otherwise.
- There is no grandfathering for internal control-related services that were pre-approved prior to the effective date of Auditing Standard No. 2 in a manner that would not satisfy the requirement in Auditing Standard No. 2 if the provision of services is ongoing after the effective date of the standard.

Scope and Extent of Testing

- The management's discussion and analysis (MD&A) does not fall within the auditor's audit scope.
- If a new system is implemented during the year, the new system is relevant to the audit of internal control over financial reporting as of the end of the year and the old system is not. However, the old system is relevant to the audit of the financial statements.
- Interim drafts of the financial statements may be shared with the auditor; however, to minimize the risk of the auditor determining that his or her involvement in the process might represent a significant deficiency or material weakness, management should clearly communicate to the auditor three things:
 - The state of completion of the financial statements,
 - The extent of the controls that had operated or not operated at the time and
 - The purpose for which the company is giving the draft statements to the auditor.

The Board provides some examples that bear a careful read by management to understand the ground rules for providing financial statement drafts to the auditor. These examples also refer to discussions with auditors regarding emerging accounting issues.

- The question arises as to what happens if management decides to forego the documentation and testing necessary to support a conclusion on internal control over financial reporting? The staff stated that in these circumstances Auditing Standard No. 2 requires the auditor to communicate in writing to management and the audit committee that the audit of internal control over financial reporting cannot be satisfactorily completed and that he or she is required to disclaim an opinion. The auditor cannot issue an adverse or a qualified opinion because in these circumstances the auditor is precluded from expressing any opinion.
- With respect to financial reporting assertions, it is not an absolute requirement to use literally the five assertions in paragraphs 69 and 70 of Auditing Standard No. 2. The staff noted that management must use assertions that have a "reasonable bearing as to whether accounts are fairly stated." To identify relevant assertions, the sources of likely potential misstatements in each account should be determined.

Evaluating Deficiencies

- The threshold for "more than inconsequential" when evaluating whether a significant deficiency exists is not necessarily equivalent to the amount the auditor establishes for purposes of listing proposed audit adjustments arising from the auditor's substantive tests during the financial statement audit. The Board's explanation of this point warrants a careful read and boils down to the auditor's exercise of professional judgment as to what constitutes a "more than inconsequential" amount; therefore, there is no requirement to align that threshold with the auditor's scope for accumulating proposed audit adjustments.
- Compensating controls are not considered in determining whether a control deficiency exists. Control deficiencies must be considered individually and in isolation.

- Compensating controls are appropriately considered when evaluating whether a significant deficiency or a material weakness exists; however, to have a mitigating effect, a compensating control must operate at a level of precision that would prevent or detect a misstatement that was more than inconsequential or material, respectively.
- Control exceptions are not necessarily a control deficiency. Paragraphs 107 and 133 of Auditing Standard No. 2 recognize the inherent limitations of internal control. Internal controls are not expected to operate perfectly, all the time, to be effective.
- A control deficiency, which in isolation is not a significant deficiency, may be considered in combination with one or more significant deficiencies to determine whether a material weakness exists.

Multi-Location Issues

- The auditor should determine significant accounts and their relevant assertions based on the consolidated financial statements and perform tests of controls over all relevant assertions related to those significant accounts at each financially significant location or business unit for which the selected accounts are material at the account level. The auditor is not required to test controls for all relevant assertions for a significant account at a financially significant location where the significant account is immaterial.
- The staff indicated that the definition of “a large portion”, for purposes of defining testing coverage, is intended to be principles-based and is left to auditor judgment. The staff recognized that auditors are defining “a large portion” differently, citing 60% and 75% as examples.
- Auditors may test using either statistical or non-statistical samples. However, the locations or business units should be selected in such a way that the sample is expected to be representative of the entire population.
- When non-statistical samples are used, the auditor’s sampling is based on the expectation of “no, or very few, control testing exceptions.”
- Auditors may not rely solely on company-level controls without also testing controls over all relevant assertions related to significant accounts and disclosures.
- When management is allowed to exclude certain entities from the company’s assessment by the SEC, the auditor should include a disclosure (similar to management’s disclosure in the internal control report) in an explanatory paragraph or as part of the scope paragraph in the audit report. There is no scope limitation.

Using the Work of Others

- With respect to the auditor’s testing of the work of others to evaluate the quality of that work, Auditing Standard No. 2 provides for flexibility. Testing the work of others in every significant account in which the auditor plans to use their work is not required.
- The auditor’s testing of the work of others does not “count” toward the auditor’s obtaining the principal evidence supporting his or her opinion. However, the auditor’s independent testing in areas in which the auditor is using the work of others does “count”.

Third Party Service Organizations

- The PCAOB staff provides examples of outsourcing activities that are part of a company's internal control over financial reporting. An important point made by the staff is that the use of a specialist is not part of a company's information system. For example, a company might outsource actuarial services; however, the nature of these services involves the use of a specialist.
- There is no "bright line" test as to when a significant period of time has elapsed between the period covered by the service auditor's report and the date of management's assessment.
- A registered public accounting firm need not issue the service auditor's report.